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TAIBBLOG

Okay, Enough: Stop Feeling Sorry for Misha Khodorkovsky

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I don't want people to think I'm busting on Joe Nocera of the *New York Times* – that's not my intention at all – but I feel like I have to say something about his column, "Russian Justice." It's yet another in a long line of pieces written by Western reporters criticizing the Putin administration for throwing "businessman" **Mikhail Khodorkovsky** in jail on trumped-up charges as part of an ongoing power play.

These Western critics are absolutely right to jump down Putin's throat for using prisons and cops (to say nothing of assassinations) as weapons to deal with unwelcome political challenges. Putin has behaved like a tinpot dictator and this over-the-top thuggery should definitely be condemned.

But I'm getting tired of reading about how Mikhail Khodorkovsky, the former chief of the oil company Yukos and the bank, Menatep, is some kind of martyr to free capitalism. Western reporters always introduce Khodorkovsky by mentioning his "murky" activities in the mid-nineties, activities that may have been legally questionable, but were "emblematic of the times" and "part of the Wild West atmosphere of the Yeltsin era." This has become a self-justifying cliche and I think those American reporters who didn't live there don't really understand what they're saying when they write these things.

Mikhail Khodorkovsky stands behind a glass wall at a courtroom in Moscow, on May 17, 2011.

Here's how Nocera put it:

The founder of Yukos, the country's best-run oil producer, Khodorkovsky undoubtedly played fast and loose in building the company in the early 1990s.

The plutocrats had no problem with that. But then Khodorkovsky did two things that made him intolerable. He began transforming Yukos into a legitimate company that played by the rules of Western capitalism.

On the part about transforming Yukos into a legitimate company ... I have no comment on that, at least not today. But Nocera, in describing how Khodorkovsky played "fast and loose" in building Yukos, leaves out one important detail: *he stole the fucking company!*

Khodorkovsky acquired his controlling stake in Yukos via the "loans-for shares" privatization auctions in the mid-nineties. In those auctions, the Russian state essentially sold off stakes in giant government-owned industrial companies in exchange for cash, the ostensible object being twofold: raise money for the cash-strapped state and also speed up the transformation from a Soviet command economy to a capitalist system.

But Khodorkovsky didn't do much to add cash to the state's coffers, because he got the money to buy Yukos from ... the Russian government! In those days the Russian Central Bank farmed out some of its operations to private banks. As part of that policy, Menatep ended up holding billions in state funds that were meant to be distributed for government actions, like for instance the prosecution of a war in Chechnya. A state audit eventually found that some $4.4 billion in Russian government money was never returned to the state by Menatep. And a research paper by the Harvard Business School concluded that Menatep was many billions in debt to the the Russian state when it made its winning bid for a controlling stake in Yukos for the preposterously low price of $350 million.

Even better, Khodorkosky got his buddies in the Yeltsin administration to allow Menatep to administer the Yukos auction; it naturally excluded its rivals from bidding on the stake, making the Yukos auction a one-horse race. As the late Paul Klebnikov of *Forbes* put it:

Khodorkovsky's Bank Menatep was put in charge of processing the bids in the Yukos auction. The winner turned out to be a company controlled by ... Khodorkovsky and his partners. A rival bid by three big Russian banks, which offered more money than Khodorkovsky's outfit, was disqualified on technical grounds.

The $350 million that Khodorkovsky and his partners paid for control of 78% of Yukos was quite the bargain. It implied a value for the whole company of $450 million. When the shares began trading less than two years later, Yukos' market capitalization was $9 billion. Today the market cap is closer to $15 billion.

Thus Khodorkovsky not only got his stake in Yukos with other peoples' money, he did so through a rigged auction that left him bidding on one of the biggest companies in the world with no rivals, for a ridiculously low price.

All of which makes passages like this one written by Nocera, describing Khodorkovsky's later detention/repression at the hands of Putin, seem more absurd:

Yukos was taken from Khodorkovsky and the shareholders in a bogus transaction, and handed to Rosneft, a more pliable oil company run by executives aligned with Putin's cronies. Khodorkovsky and

Lebedev, his longtime business partner, were arrested, convicted of trumped-up tax fraud charges and sentenced to eight years in prison that began in 2003.

Putin is definitely a thug and he should be condemned for using these tactics. But making Khodorkovsky out to be a symbol of fair business practice doesn't make sense either. This isn't about ideology. To quote *Goodfellas*, this is all "real greaseball shit." Khodorkovsky was an ex-Komsomol insider communist hack who was handed a huge company by his thug pals, but when his gang asked him to toe the line and his Don, Vladimir Putin, asked him to do a service, he balked and went solo. So they took back his cheese and threw him in jail. That's all that went on here. It sucks for him, and it's not a particularly great sign for the future of Russian business, but the whole narrative falls pretty far short of lofty terms like "injustice."

The Oligarch Who Came in from the Cold

Paul Klebnikov, 03.18.02

Billionaires

Not long ago Mikhail Khodorkovsky was vilified in the West as a crony capitalist who stiffed foreign business partners. Now he is Russia's richest man and appears to be the West's best friend.

If your business gets some benefit from cheap energy, send a note of thanks to Russian oligarch Khodorkovsky. It may seem strange to attribute power over world energy prices to this soft-spoken 38-year-old. Even if he is Russia's richest man, with an estimated net worth of $3.7 billion, and controls the country's second-largest oil company, his business is still dwarfed by the Saudi Aramcos, ExxonMobils and Royal Dutch/Shells of the world.

But Khodorkovsky is in the right place at the right time. Russia, the world's second-largest exporter of oil and oil products (after Saudi Arabia), has come under intense pressure recently from OPEC to join in export cuts and push up oil prices. Thirty-dollar oil would be much better for the Russian economy than $15 oil, but the Russian government has declined to make anything more than a symbolic export cut.

What is behind this policy? Keeping OPEC at bay may be one of the concessions that Vladimir Putin made to George W. Bush when he visited the American president in November. But the Russian government is also responding to pressure from its own oil magnates.

This is where Mikhail Khodorkovsky comes in. His company, **Yukos, accounts for 17% of Russia's oil production** and has significant influence in the Kremlin. One former employee was, until recently, the minister of fuel and energy; another former Khodorkovsky sidekick is currently Vladimir Putin's deputy chief of staff. Among Russian oilmen, Khodorkovsky is the leading advocate of ignoring OPEC's demands and expanding production as rapidly as possible. Which he is doing: Yukos has expanded production by 35% over the last two years, to 1.2 million barrels a day. Cap some wells? He won't do it.

While other Russian oil giants, such as Lukoil, have spoken out in favor of accommodating OPEC, so far it is Khodorkovsky's side that is winning in the Kremlin. The stakes are huge--both for world oil prices and for the world economy.

To visit Mikhail Khodorkovsky, you drive an hour west of central Moscow to **Zhukovka, an elite suburb that was once home to Politburo members and Soviet Army generals**. There Khodorkovsky and a half-dozen of his partners have built a compound of luxury houses among the pine trees. The houses are tasteful and the place is beautiful, but the compound itself bears a resemblance to a prison camp. It is surrounded by high walls, with powerful lights every 30 paces. Guards with machine guns patrol the perimeter. At the massive entrance gate, mirrors check the underside of visitors' vehicles for car bombs. Americans have been preoccupied with security only since September. **Russian executives have needed bodyguards ever since capitalism came to the country**.

Khodorkovsky is an unassuming man. The oldest of his four children is in a Swiss boarding school, but otherwise Khodorkovsky seems to avoid the nouveau riche trappings of other Russian oligarchs.

Doesn't he have a villa on the Riviera? "My wife and I don't like the beach much," is his reply. "This past winter holiday we spent happily in a small hotel in Finland."

Khodorkovsky has an earnest demeanor and a high-pitched voice that is often difficult to hear, but appearances are deceiving. This is a tenacious and ruthless businessman.

Amoco, now part of BP, can testify to that. Until a few years ago Amoco had placed great hopes on the **Priobskoye field in western Siberia**. Some 3.5 billion barrels of oil lie beneath this desolate stretch of marsh and arctic forest. The field, which Amoco was developing with a Yukos subsidiary, promised to be a gusher. But in 1998, at the very moment when large-scale production at Priobskoye was set to begin, Amoco was sent packing; it had to eat the estimated $300 million it had spent on the project. Today BP declines to say much about the affair. Here is Khodorkovsky's version of what happened:

"This was the result of their own hesitation," he says. "Amoco was granted exclusive rights to negotiate for the Priobskoye field and continued these negotiations for five years. In 1997 [when I gained full control of Yukos], I inquired whether there was any document that required us to continue negotiations with Amoco. [There wasn't.]"

With Amoco out as an equity partner, Khodorkovsky brought in other Western companies on a fee basis: oil service outfits, such as Schlumberger (see story, p. 76) and the Anglo-Norwegian outfit, Kvaerner, to help him tap Priobskoye and to revive older fields. Now production at Priobskoye is rising briskly, from 40 million barrels last year to a likely 90 million this year.

Though Yukos' proven reserves (12 billion bbl. of oil equivalent) put it in the league of ChevronTexaco, its financials make it middling by Western standards: Moscow-based brokerage United Financial Group estimates Yukos earned $3.7 billion on revenues of $7.3 billion last year. Khodorkovsky has grand international ambitions, though. He plans to buy refineries and gas stations in Europe and to take the lead in a $1.7 billion pipeline to pump Siberian oil to China.

Khodorkovsky has come a long way from his impoverished Soviet childhood. He grew up in a cramped communal apartment in Moscow; he and his parents shared two rooms. Khodorkovsky was a model Soviet youth. He was a good student, finished the Mendeleev Institute of Chemical Technology and became deputy head of the Communist Youth League at his institute.

He was fortunate to be embarking on a career just as Mikhail Gorbachev was reforming the Soviet Union. It was under the aegis of the **Communist Youth League** that Khodorkovsky first went into business. **Together with a half-dozen partners, he started a private cafe, peddled new**

technologies to Soviet factories, imported PCs, even sold French brandy.

By 1988, less than two years after he started his trading business, Khodorkovsky was hauling in revenue of 80 million rubles a year ($130 million according to the official exchange rate, $10 million according to the black market rate). This made Khodorkovsky one of the most successful of Russia's new breed of wheeler-dealers. Was this the result of good contacts with the political elite? Khodorkovsky says no.

Flush with cash from his trading operations, Khodorkovsky and his partners established Bank Menatep. As one of Russia's first privately owned banks, Menatep expanded with dizzying speed, not only by financing Khodorkovsky's lucrative trading operations, but also by handling state money, such as the funds allocated for the victims of the Chernobyl nuclear accident. By 1990, a year before the fall of communism, Menatep was conducting operations offshore. It was first a client, and later a shareholder, of a private bank in Geneva called Riggs Valmet.

This was when Russian private banks were widely suspected of spiriting away billions of dollars belonging to the Communist Party into anonymous offshore accounts. Khodorkovsky says his bank kept its hands clean. "Our bank was subjected to rigorous checks on this score," he says. "And I can say that at least in our bank no such funds were found."

After communism fell and Boris Yeltsin came to power, Menatep's fortunes continued to rise. It was authorized to handle the funds of the Ministry of Finance, the State Taxation Service, the Moscow city government and the Russian arms export monopoly. Meanwhile, Khodorkovsky's trading operations had begun to take on international commodity shipments. There were deals with **Marc Rich**, the pardoned fugitive, and a big oil-for-sugar deal with Cuba.

But it was in acquiring Yukos that Khodorkovsky hit the big time. His chance came in the loans-for-shares auctions in 1995, when the government unloaded its majority stakes in Russia's top oil and metals companies to a group of well-connected financial companies.

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"In those days everyone in Russia was engaged in the primary accumulation of capital," Khodorkovsky recalls about the anarchic Yeltsin years. "Even when laws existed, they were not very rigorously followed. Therefore, if you conducted yourself too much in a Western manner, you were simply torn to pieces and forgotten."

Khodorkovsky's next big challenge came in August 1998. Hardly had he finished consolidating his control over Yukos and shooing off Amoco when the whole Russian financial system collapsed. Looted by its crony capitalists, Russia was bankrupt. The government devalued the ruble and defaulted on most of its debt. Most of Russia's big private banks went under--including Bank Menatep-Moscow.

Khodorkovsky and his partners salvaged what they could out of the rubble, transferring their good accounts to a sister bank called Menatep-St. Petersburg. But they were still left with the question about what to do with their angry creditors. Chief among these was a group of foreign banks, which had lent Menatep $266 million, secured by a 33% stake in Yukos.

Khodorkovsky's group urged the foreign banks to accept a three-year repayment plan, secured by oil exports rather than Yukos shares. But the two largest creditors, Daiwa Bank and West Merchant Bank (a subsidiary of Westdeutsche Landesbank), refused. They took ownership of their collateral (representing 29% of Yukos' shares), but made it clear that they were primarily interested in getting their money back. After negotiations between the banks and Khodorkovsky's people collapsed in the summer of 1999, Daiwa and West Merchant dumped their Yukos shares on the market. Although the sale price has not been made public, it is estimated that the two banks got back only half the value of their loans.

On the surface, it seemed like a crazy decision. Why the hurry? If the two banks had waited a few months for the initial stock market panic to pass, they could have made a handsome profit from selling their Yukos shares. What spooked them into selling?

At the same time that the Khodorkovsky camp was negotiating loan restructuring terms with West Merchant and Daiwa, it was announcing pending share offerings in Yukos and its subsidiaries that would have diluted Daiwa's and West Merchant's 29% stake to insignificance.

"This was a normal defensive maneuver," says Platon Lebedev, director of Group Menatep, the holding company representing Khodorkovsky and his six partners. "We had to save Yukos, so we had to have a share issue to raise more equity capital. If the banks wanted to own shares of Yukos, they should have acted like shareholders and subscribed to the share offering."

Meanwhile, Yukos was selling some of its prime oil-producing assets to obscure entities offshore. Yukos seemed in danger of becoming a shell company. Not surprisingly, Daiwa and West Merchant folded their hands. Khodorkovsky and his partners bought back most of the stake themselves. The share offerings were canceled and whatever assets had been moved offshore were returned to Yukos in Russia.

It is hard to say whether or not Yukos has fully repaired its relations with foreign banks; it has no credit rating.

Today a new era is dawning in Russia. Vladimir Putin is in charge of the Kremlin. The Russian monstrosity even liberal politicians call "gangster capitalism" is giving way to a more civilized market. The financial free-for-all is yielding to an ethic of reinvesting in your business. And among the old-time oligarchs, Mikhail Khodorkovsky is leading the charge.

"By now we understand how business is done in the West," he says. "As a shareholder, I earn money in dividends and with the increase in the market capitalization of my company."

To that end Yukos has published three years of accounts meeting U.S. GAAP standards, has issued an ADR and is paying a serious dividend (a trailing 12-month yield of 2.8% on the $98 ADR). There are five foreigners on the board of directors and the chief financial officer is an American. Yukos shares are up more than tenfold in two years, although that may be as much a function of the small free float (15% to 20% of the shares outstanding) as of the operating results.

"Previously we were all focused only on the cash revenues of our business, since no one believed that the situation would last," says Khodorkovsky. "Now that things are stabilizing, people are more interested in increasing the value of their property."

Yes, things have changed in Russia. "How? Well, for instance, I recently bought my first house," says Russia's wealthiest man, indicating the Zhukovka compound. "I simply feel more comfortable in Russia these days."

Outside, the guards with their machine guns still keep a wary eye for intruders.